2006/2007 : Report 8

OFFICE OF THE

Auditor General of British Columbia

Changing Course — A New Direction for British Columbia's Coastal Ferry System

A Review of the Transformation of BC Ferries

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OFFICE OF THE
Auditor General
of British Columbia

LOCATION:
8 Bastion Square
Victoria, British Columbia
V8V 1X4

OFFICE HOURS:
Monday to Friday
8:30 a.m. – 4:30 p.m.

TELEPHONE:
250 387-6803
Toll free through Enquiry BC at: 1 800 663-7867
In Vancouver dial 660-2421

FAX: 250 387-1230

E-MAIL: bcauditor@bcauditor.com

INTERNET HOMEPAGE:
This report and others are available at our Website, which also contains further information about the Office: www.bcauditor.com

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OFFICE OF THE
Auditor General
of British Columbia

8 Bastion Square
Victoria, British Columbia
Canada V8V 1X4
Telephone: 250 387-6803
Facsimile: 250 387-1230
Website: http://bcauditor.com

The Honourable Bill Barisoff
Speaker of the Legislative Assembly
Province of British Columbia
Parliament Buildings
Victoria, British Columbia
V8V 1X4

Dear Sir:

I have the honour to transmit herewith to the Legislative Assembly of British Columbia my Office's 2006/2007 Report 8: Changing Course — A New Direction for British Columbia's Coastal Ferry System: A Review of the Transformation of BC Ferries.

Arn Van Iersel, CGA
Acting Auditor General

Victoria, British Columbia
December 2006

copy: Mr. E. George MacMinn, Q.C.
Clerk of the Legislative Assembly

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The coastal ferry system is a critical part of British Columbia's transportation system. Hundreds of thousands of British Columbians and visitors rely on it to transport food, other goods and themselves between the Lower Mainland, the islands and coastal communities. In a typical year, BC Ferries carries over 20 million passengers and 8 million vehicles.

On April 2, 2003, the Province gave up operating and financial control of BC Ferries by creating the B.C. Ferry Authority and transferring legal ownership of the British Columbia Ferry Corporation to the Authority, an entity designed to be independent of government. The reasons for this move were to resolve longstanding governance problems, and to create a coastal ferry system that would be sustainable into the future. In recent years, a major concern has been the aging fleet. In the next dozen years, a significant number of vessels will have to be retired and replaced with new vessels if service is to improve, or even to continue at current levels.

Previously, as a Crown corporation, BC Ferries was responsible for operating the ferry system, but its board did not have the final say over operations, capital replacement and financing. Instead, government made the important decisions. This did not allow BC Ferries to follow proper business practices—one result of this divided governance model was that the timing of capital spending (principally for the replacement of older ferries) was often influenced by government's competing public policy priorities.

To assess whether BC Ferries' structural transformation is meeting government's objectives for the province's ferry system, our Office conducted a review of the new structure, and of how progress in meeting the objectives is monitored and reported to government and the public.

The new structure has achieved its immediate purpose

We concluded that the changes made to the governance structure, brought about by the *Coastal Ferry Act*, have achieved their immediate purpose: the separation of government policy decisions and BC Ferries' business decisions. The new BC Ferries, (the B.C. Ferry Authority and its operating company, British Columbia Ferry Corporation, now renamed British Columbia Ferry Services Inc, collectively) is sufficiently independent that it can make its own

business decisions, including those related to the timing and cost of ferry replacement. The Province, however, ultimately retains the major risks and benefits of ownership, since any increase or decrease in the value of the company would translate into gains or losses to the Province should the company ever be sold. At the same time, by negotiating service levels in the Coastal Ferry Services Contract, government has the ability to ensure that British Columbia's coastal economy receives the ferry service necessary to sustain it. That contract sets out what ferry services will be provided and what BC Ferries will be paid in return.

BC Ferries' governance has changed significantly

The other side of BC Ferries' increased independence is decreased control by government. As a Crown corporation, the company was answerable to its shareholder, that is, government and the Legislative Assembly, in the same manner that a private sector company is answerable to its shareholders. The B.C. Ferry Authority, however, is neither a Crown corporation nor a private sector company but an independent authority, answerable to no owners or shareholders. The directors who control the Authority have no financial stake in the company, and as a result the Authority may be less affected by market and regulatory pressures.

We note that similar independent authorities have been adopted elsewhere to manage transportation infrastructure such as air and seaports. For example, the Vancouver International Airport Authority (VIAA) manages Vancouver International Airport. There is no "standard" authority model, however, and there are differences in how directors are appointed and how the authorities are governed. BC Ferries also differs from VIAA in that, in addition to managing the terminal infrastructure, it also operates the ferry service – VIAA manages the airport, but does not operate an airline.

While there is no person or agency that controls BC Ferries, or its board of directors, there are other constraints on the company. These are imposed largely by the *Coastal Ferry Act* (which includes regulation by the BC Ferries Commissioner) and the Coastal Ferry Services Contract which provide incentives for the company to act in ways that will further the Province's objectives. There are also constraints imposed by the selection process for the directors, by securities regulators and to some extent by public opinion.

It is important to note, however, that the Coastal Ferry Services Contract is a long-term commitment, binding the Province for the next 60 to 80 years. During that time, the only terms that are to be periodically renegotiated are core service levels and the service fees to be paid for those services. If circumstances change in the future so that the objectives of the transformation are not being met, the only sure means government has to correct the situation is to repeal or revise the legislation.

Deputy Auditor General's Comments

Government is seeking to make the ferry system sustainable through reduced dependence on public funding

In order to reduce the costs of the ferry system, improve service and increase revenue, government has restructured the operating company, British Columbia Ferry Services Inc., along the lines of a private-sector company. The enabling legislation also opens the way to move a larger share of the cost of the ferry system to those who benefit most, i.e., those who use the ferries, thereby further reducing the cost to taxpayers.

Competition can be a mechanism to achieve cost efficiencies. BC Ferries is required to seek out alternative service providers who might provide, under contract or other agreement, service on designated routes at reduced cost. We believe, however, that the monopoly position of BC Ferries, both in ferry operations and control of the terminals, along with the apparent conflict of interest inherent in accepting tenders from others while also providing ferry services, will hinder the reduction of costs through competitive pressure.

To guard against monopolistic behaviour as a result of the restructuring, the government created the position of the British Columbia Ferries Commissioner. The Commissioner is responsible for regulating and monitoring both ferry service and fares to ensure that BC Ferries delivers the contracted level of service and that average fares do not exceed maximum limits. The Commissioner can enforce his or her orders by imposing financial penalties on the company. Due to the absence of any financial impact on those controlling BC Ferries, however, we question how effective these penalties can be in ensuring compliance.

Deputy Auditor General's Comments

Some monitoring is carried out, but more could be done

The Ferries Commissioner is not the only entity monitoring BC Ferries. The Ministry of Transportation also monitors the company to ensure that it is complying with the Coastal Ferry Services Contract. The contract requires that the ministry and BC Ferries jointly develop performance measures for monitoring the quality of service, but this had not been done at the time of our review.

We found reporting on the new structure to be somewhat fragmented. Rather than there being a single source of complete information on the ferry system, both the operating company, British Columbia Ferry Services Inc., and the B.C. Ferry Authority issue their own annual reports (and each holds its own annual general meeting, which is open to the public). The Commissioner issues an annual report which is tabled in the Legislature.

In Summary

Government has created a structure to achieve its immediate objective, but the real test of this structure is still in the future

We believe that, with the transformation of BC Ferries, government has created a structure that has achieved its immediate objective and has the potential to achieve more. Already, it appears to have achieved separation of public policy and business decisions, opening the way for a new capital program to replace aging ferries and other infrastructure.

We do not believe that the absence of direct accountability to the Province will be detrimental to performance in the short term. Over the 60 year term of the Coastal Ferry Services Contract, however, the interests of BC Ferries and the Province may diverge, requiring the Province to take action.

We have reservations about whether cost reduction through competitive pressure is possible under the new structure, but do not believe this to be an over-riding weakness in the overall model.

Our review did not reveal any other significant weaknesses in the steps taken to make the ferry system sustainable. It is too early, however, to determine whether all of the objectives of the transformation will be achieved.

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The test of the new coastal ferry system is still in the future. The ferry services to be provided and the fees to be paid for these will be renegotiated between government and BC Ferries for the performance term starting in 2008, and the first of the new C-class ferries currently contracted for will enter service at about the same time. The cost to both taxpayers and ferry users almost certainly will be affected by these, and other, events. BC Ferries' performance over the next few years will also affect its ability to raise funds for further capital spending. It will be at least 2008, and possibly later, before anyone will know whether or not government has fully realized its objectives in restructuring the ferry system.

Key Findings and Recommendations

There are no criteria by which government can measure whether or not the new ferry structure is achieving the objectives of the *Coastal Ferry Act*.

- *Government should establish criteria for evaluating how well the coastal ferry system is achieving the objectives of the transformation and conduct evaluations of that performance, at least once in every performance term, in order to determine when or if changes to the* Coastal Ferry Act *should be made.*

The ferry system is administered by a collection of separate legal entities, each of which issues a report on its activities. There is no single report that covers all aspects of the ferry system.

- *The Ministry of Transportation should issue, separately or as part of its annual service plan report, a comprehensive summary report on the coastal ferry system.*

The Coastal Ferry Services Contract requires government and BC Ferries to develop performance measures relating to the quality of service provided. This has not yet been done.

- *The Ministry of Transportation and BC Ferries should develop performance measures relating to the quality of service, as required by the Coastal Ferry Services Contract.*

The BC Ferries Commissioner plays a key role in the new coastal ferry structure and is well placed to identify potential problems and solutions, however we note that a concern raised in all three of his reports to date does not appear to have been addressed by government. The Legislature is not obligated to respond to concerns

Deputy Auditor General's Comments

raised by the Commissioner, however given the role played by the Commissioner, Legislators may wish to consider how best to address his concerns.

I wish to thank those who assisted and cooperated with our Office in gathering information for the review. As well, I would like to acknowledge the hard work, professionalism and dedication of Office staff in the production of this report.

Errol S. Price, CA, CMC
Deputy Auditor General

Victoria, British Columbia
December 2006

Audit Team

Russ Jones

Jamie Orr

Laurie Selwood

The *Coastal Ferry Act* was intended to make BC Ferries independent of government. One of the results of this is that, in accordance with generally accepted accounting principles for government financial statements, the corporation's financial statements are no longer included in the consolidated Summary Financial Statements of the Province. This means that, although the Province's investment in BC Ferries continues to be reported, the underlying assets and liabilities of BC Ferries are no longer reported as assets and liabilities of government—BC Ferries is outside what is termed the Government Reporting Entity.

As auditor of the Province's Summary Financial Statements the Office of the Auditor General reviewed and approved this change in accounting at the time it was made. Since accounting standards continue to evolve, however, and circumstances change, it is possible that in the future conditions will again require the inclusion of BC Ferries in the Government Reporting Entity. This Office periodically reviews the Province's accounting for its interest in BC Ferries to ensure that it remains in accordance with generally accepted accounting principles.

Background

Source: British Columbia Ferry Services Inc.

As part of its Core Services Review in 2001 and 2002, government examined a variety of potential business models for BC Ferries, ranging from retaining the status quo to outright sale and privatization. To balance the many factors, interests and requirements of the coastal ferry system, government selected what it considered a middle of the road option.

On April 2, 2003, the Province transferred control of BC Ferries to the newly created B.C. Ferry Authority. At that time, BC Ferries ceased to be a Crown corporation and was reincorporated under the *Company Act* (now the *Business Corporations Act*). This change marked the end of 43 years of government-provided ferry service to British Columbia's coastal communities. Although the Province continues to provide some 19% of BC Ferries revenue, government no longer directs the operations and financing of these services.

Background

The coastal ferry system is significant. Since the Province launched its first two ferries in 1960, this system has grown to be one of the three largest in the world (the others being Scandlines and Washington State Ferries). At March 31, 2003, immediately before the transformation, BC Ferries operated 35 vessels, traveling between 47 ferminals on 25 routes. In the 12 months before that date, it carried more than 21 million passengers and 8 million vehicles. Its assets were valued at over half a billion dollars.

The ferry system is critical to British Columbia's coastal economy. Vancouver Island, the Gulf Islands and many communities up and down the length of the west coast are almost entirely dependent on this system to transport both people and a wide range of products, including fuel and food. At present there is no alternative service that can handle the volume required. This importance has been recognized in the *Coastal Ferry Act*, which deems that "the delivery of ferry services is necessary for the protection of the health, safety and welfare of the residents of British Columbia." In short, the ferries provide an essential service.

Although the *Coastal Ferry Act* was passed in 2003, many of the changes will not be felt until 2008. At that time, the Province and the company will renegotiate service levels and fees paid by the Province. Ferry service or fares may change as a result of these negotiations. At approximately the same time, the first of three new C-class ferries presently being built in Germany will go into service, followed soon after by the others. These new vessels will also have an impact on fares and service fees, as may three other new vessels expected to enter service between now and 2009.

One of these new vessels is the *MV Sonia*, which BC Ferries recently announced it had purchased to replace the *Queen of the North*, lost in March of 2006. A negotiated increase in service fees on the affected routes was also announced, which will take effect when the *Sonia* is put into service in 2007.

New services and new ways of providing existing services may be introduced as part of continuing efforts to improve customer service and reduce costs. Changes will continue into the future as more vessels and other infrastructure are replaced and as the coastal ferry system evolves to meet new demands.

Background

Problems in BC Ferries had been well known for many years

At the time of the transformation, BC Ferries was facing several challenges. The most pressing was the need to replace over half of the ferry fleet and make other infrastructure investments. Estimates of the amount of spending required to do this were as high as $2 billion over the next 15 years.

How BC Ferries was governed and how decisions were made for the company were seriously affecting its ability to replace vessels. Following the failure of the Fast Ferry Project in 1999, this Office issued the report *A Review of the Fast Ferry Project: Governance and Risk Management*. In that, we made the following observations:

> *"The idea of using Crown corporations to deliver publicly provided services of a commercial nature is sound. Properly applied, such an administrative mechanism can be more cost-effective than direct service by government because it gives more room for the application of business practices. However, BC Ferries has not been allowed to apply these practices in an organized and consistent way.*
>
> *"The Act setting up BC Ferries provides for cabinet, not the corporation's board, to make most key decisions, including approving route additions or deletions, approving fares, toll and other charges, and approving corporate borrowings. Also, since capital plans need cabinet approval and capital budgets need Treasury Board approval, construction of ferries or terminals is also ultimately a government decision. In short, the corporation does not have control over most significant decisions that affect its financial and operating performance.*
>
> *"Most key business decisions are made outside BC Ferries (and, at times, contrary to BC Ferries' advice), by elected officials who also have responsibility for many other important areas of government. As a result, decisions about BC Ferries' business are often ad hoc and lack consistency. For example, decisions about fares have not always been integrated with decisions about subsidies, routes, capital expenditures, or service levels.*
>
> *"This means that the government is unlikely to get the benefits of a Crown corporation approach—a serious disadvantage, given that BC Ferries operates an essential part of the province's transportation system, and is vital to the social and financial well-being of many Vancouver Island and other coastal communities."*

In that report, we also pointed out that these governance problems were not new, but had been in existence for many years:

> *"In 1981, the Select Standing Committee on Crown Corporations of the Legislative Assembly carried out a review of BC Ferries. Its report noted: 'The future effectiveness of the ferry system would seem to require that the directors have somewhat greater control over these important aspects of their business. …[The] present division of responsibilities between the Lieutenant Governor in Council and the board creates a situation in which the clarity of the board's mandate to plan, develop, and operate the ferry system is clouded.' In our opinion, the committee's comments are still valid today."*

The mixing of BC Ferries' business and government's policy decisions referred to above contributed to insufficient capital spending, which in turn contributed to the current problem of an aging fleet. The spending that occurred was not always in accordance with BC Ferries' needs. The new separation of BC Ferries' business decisions from other considerations will, we believe, provide the board of BC Ferries with the ability to plan and carry out a program of ship acquisition that will meet the needs of the ferry system.

The transformation of BC Ferries is also intended to create a ferry system that, by reducing its dependence on the taxpayer through sound business principles, will be more sustainable in the long term. While it is unlikely that the ferry system can ever be made completely self-sustaining, the Act seeks to shift more costs to the ferry user while at the same time reducing the total cost of the system from what it would have been under the old administration. The Act also seeks to introduce competition in order to apply further pressure to improve customer service and reduce costs.

Purpose of Review

Purpose of Review

Three years after government's transformation of BC Ferries, we sought to answer the following questions:

1. Are government's objectives in making the transformation likely to be achieved with the mechanisms in place?
2. How is progress towards these objectives being monitored, measured and reported to government, the Legislative Assembly and the public?

In carrying out our review, we examined the *Coastal Ferry Act*, relevant contracts and agreements, and other documents connected with the changes. We also interviewed government personnel, employees of the former Crown corporation and others connected with the new structure of the coastal ferry system.

The focus of this review was the governance structure created for the coastal ferry system and implemented by government in April of 2003. Our approach was to identify potential risks and to assess the extent to which these risks had been mitigated. This was not intended to be a review of day-to-day operations, and, therefore, we did not review any particular actions that BC Ferries may have taken.

We gathered the information for this report between October 2004 and August 2006. Our review was carried out in accordance with assurance standards recommended by the Canadian Institute of Chartered Accountants, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

Detailed Report

Government had five main objectives in changing the structure of BC Ferries

To assess the effectiveness of the changes to British Columbia's coastal ferry system, we first needed to identify government's objectives in realizing the change. The objectives are not stated in a single document, so we consulted several sources to determine what they were: the Act itself, records published in *Hansard* and press releases. We also interviewed the members of the steering committee that had been charged with designing and implementing the transformation.

We determined that there were five main objectives, aligned around two overall intentions:

- To improve governance by:
  1. separating public policy decisions from operating and financing decisions of the ferry system; and
  2. making the cost of the ferry system transparent to the taxpayer.
- To ensure long-term sustainability by:
  3. minimizing the cost of the ferry system to the taxpayer by reducing costs and shifting a larger share of those costs to ferry users;
  4. protecting the ferry system in the long term; and
  5. improving service to the customer.

It is clear that some of these objectives will conflict with others from time to time. Minimizing costs to taxpayers, for example, could conflict in the short term with protecting the ferry system and improving service. It remains to be seen how BC Ferries, under the guidance of the Ferries Commissioner, will resolve any such conflicts in the future.

The *Coastal Ferry Act* created a new structure for the coastal ferry system

The new structure for delivery of coastal ferry services is made up of four main components, all of which are enabled or created by the *Coastal Ferry Act*. These are:

- the B.C. Ferry Authority and British Columbia Ferry Services Inc.—collectively called BC Ferries;
- the transfer and lease of the terminal properties;
- the Coastal Ferry Services Contract; and
- the British Columbia Ferries Commissioner.

BC Ferries

The purpose of the B.C. Ferry Authority appears to be to separate government from the operating company, British Columbia Ferry Services Inc. (BCFS).

Although there are two separate Boards of Directors, the B.C. Ferry Authority holds the single voting share of BCFS and appoints the directors of BCFS. Currently all directors of the Ferry Authority are also directors of BCFS (although the opposite is not the case). For convenience in this report, we refer to both bodies together as BC Ferries, or 'the company', unless otherwise noted.

The B.C. Ferry Authority—The B.C. Ferry Authority is the legal owner of British Columbia Ferry Services Inc. (which was formerly British Columbia Ferry Corporation).

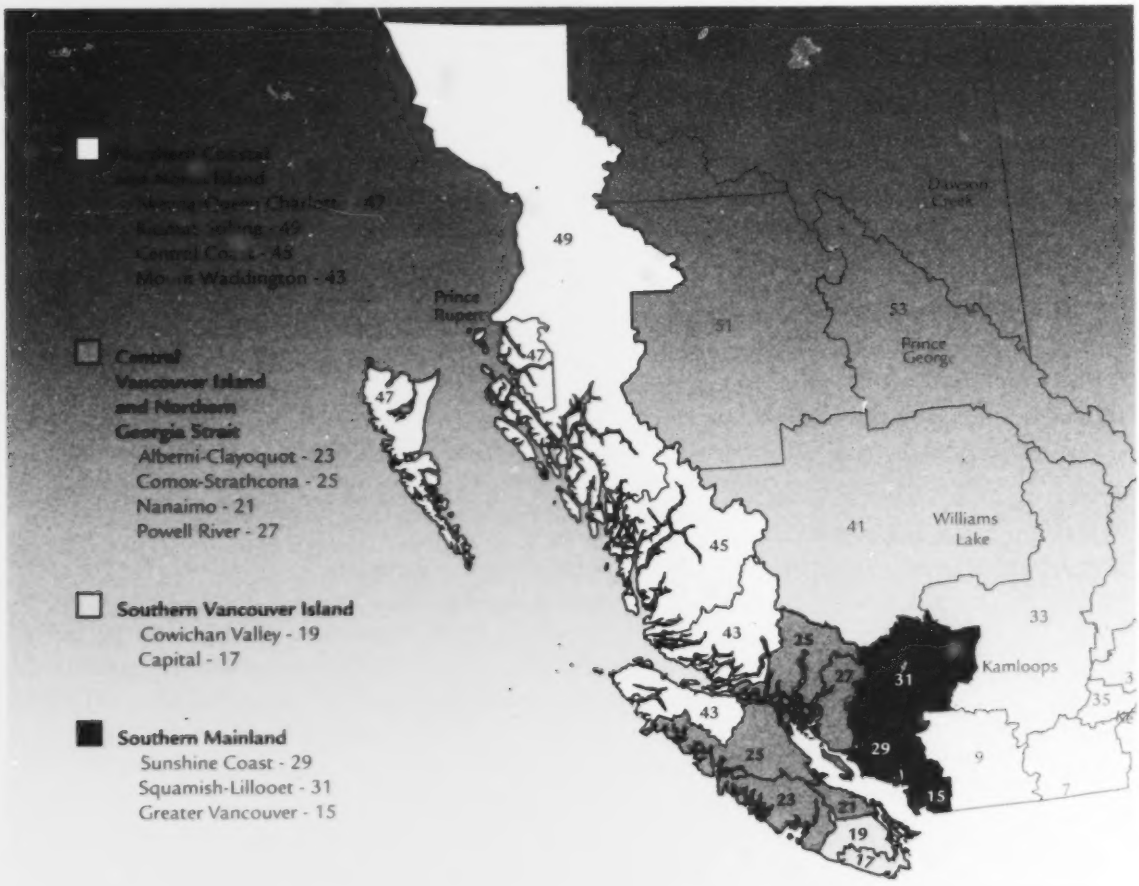
Created by the *Coastal Ferry Act*, the Ferry Authority was structured to be an independent entity outside the control of government or any other organization. It is essentially a holding company, created for the purpose of owning the only common (or voting) share issued by BCFS. As sole shareholder, the B.C. Ferry Authority has the power to appoint all members of the Board of Directors of BCFS.

Because the B.C. Ferry Authority has no share capital, it also has no shareholder who can control it through its Board of Directors. Although the Province appointed the first members of the board, these appointments expired after one year, and now the Province has the right to appoint only two out of a total of nine Directors. No other entity or organization controls the board either. The board

itself appoints the additional seven members: one member is selected from nominees provided by the union representing the ferry workers; four are selected from nominees in four geographic appointment areas (see Exhibit A); and two are chosen directly by the other board members.

Exhibit A

Geographic appointment areas



Source: BC Stats and Order in Council No. 0541 *Designated Appointment Areas Regulation*.

The geographic appointment areas were created by organizing the existing 13 coastal Regional Districts served by BC Ferries into four larger groupings. Each appointment area includes two to four Regional Districts and each Regional District represents several

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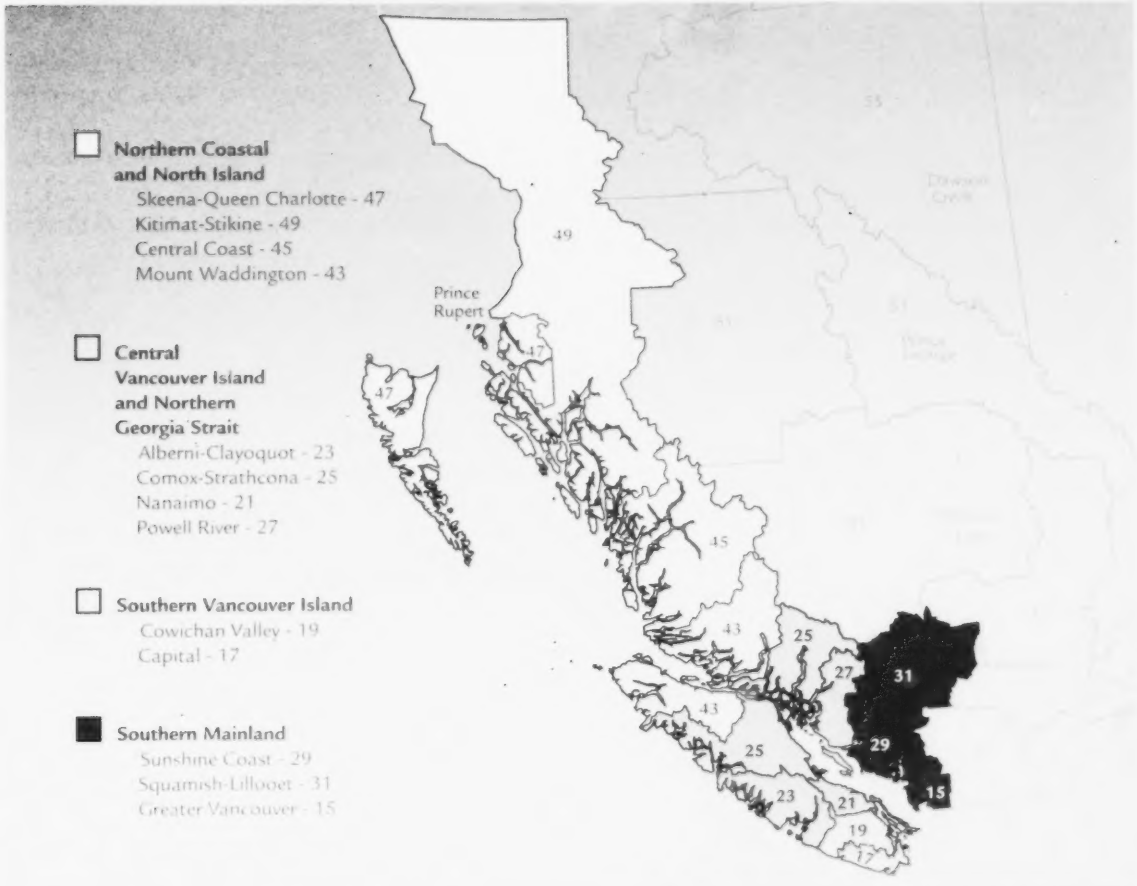
Exhibit A

Geographic appointment areas



Source: BC Stats and Order in Council No. 0543 *Designated Appointment Areas Regulation*.

The geographic appointment areas were created by organizing the existing 13 coastal Regional Districts served by BC Ferries into four larger groupings. Each appointment area includes two to four Regional Districts and each Regional District represents several

municipalities. Each appointment area is entirely responsible for how it selects its nominees, but can request guidance from the B.C. Ferry Authority in determining what skills and qualifications are required.

British Columbia Ferry Services Inc.—BCFS is the operating company that delivers coastal ferry services. The *Coastal Ferry Act* allowed the conversion of the former Crown corporation, the British Columbia Ferry Corporation, to a company under the *Company Act*, (now the *Business Corporations Act*) renamed British Columbia Ferry Services Inc.

To divest itself of the British Columbia Ferry Corporation, government allowed the company to re-purchase the common shares held by the Province. In exchange for its shares, the Province received promissory notes, secured by debentures, for $427.7 million, as well as 75,477 non-voting, 8% cumulative preferred shares valued at $1,000 each—the total representing the value of the former corporation as appraised by the Province. This value was equal to the net book value of the corporation as recorded in the Province's financial statements, and therefore no accounting gain or loss was realized on the transaction.

BCFS then issued one common (voting) share to the B.C. Ferry Authority. The Authority thus became the legal owner of BCFS, with the power to appoint the Board of Directors of BCFS.

Ownership of terminal properties

The properties making up the terminals—land, buildings, and water lot leases—were previously held by several government agencies, including the former BC Ferries. These properties, including those held by BC Ferries, were all transferred to the BC Transportation Financing Authority. Subsequently, the new BC Ferries signed agreements with the Financing Authority that transferred ownership of the buildings and improvements to BC Ferries and gave them exclusive use of the ferry terminal lands and water lots through a 60-year lease (with a renewal option for 20 years) on each of 43 terminals. The consideration for the properties transferred from the former BC Ferries was made equal to the present value of the payments on the leases, with the result that the leases are prepaid for the full 80 years.

BC Ferries is responsible for maintaining the terminals and for carrying out any new construction. BC Ferries is required to pay all costs and taxes for the terminals and has indemnified the Province against any claims concerning these properties.

The properties can be used only for the provision of ferry and ancillary services. BC Ferries may not close a terminal or significantly reduce the vehicle capacity of a terminal. Should the company be in default of its obligations under the Coastal Ferry Services Contract (see below), the Province has the right to terminate the leases and take back the terminals, in accordance with the default procedures.

Coastal Ferry Services Contract

The Coastal Ferry Services Contract between the Province and BC Ferries makes the company responsible for providing ferry services.

The services specified in the contract include the routes to be operated, the number of round trips, the hours of operations, and the capacity to be provided on each route. Collectively, these are referred to as core service levels. The initial core service levels were those already in place at March 31, 2003, immediately before the new structure came into effect.

The contract specifies service fees to be paid by government for each core round trip on each route. The routes are separated into seven groups. Service fees for the routes between Vancouver Island and the Lower Mainland are set at zero, as this route group is able to recover its costs through fares paid by ferry users. BC Ferries receives service fees for all other routes.

All payments from the Province to BC Ferries are set out in the contract. Previously, BC Ferries received a subsidy of 1.25 cents per litre from motor fuel taxes, an amount which had no relationship to ferry services provided or used. The new service fees have superseded this arrangement and payment is now linked to service provided. (The contract also includes provision for reimbursement, by the Province to BC Ferries, for the fares of for seniors, students, the disabled and medical cases who receive subsidized service.)

The core services covered by the contract include only those directly related to the transportation of vehicles and passengers. Any services not directly related to that purpose are defined as ancillary services. Examples of the latter include parking, catering and retail concessions and reservations. This distinction is significant, as ancillary services are not subject to regulation by the British Columbia Ferries Commissioner.

As noted above, the total term of the Coastal Ferry Services Contract is 60 years, with a 20 year renewal option. Core services and service fees are to be reviewed and renegotiated at the beginning of every four-year performance term. The initial performance term is set for five years. Should BC Ferries default on the contract, the Province has various remedies, including repurchasing the vessels.

British Columbia Ferries Commissioner

In industries where there is no competition, governments commonly use a regulator to protect the public from artificially high prices or inadequate service. The British Columbia Ferries Commissioner, a position created by the *Coastal Ferry Act*, is such a regulator.

BC Ferries holds a monopoly position due to its control of the ferry terminals. The scarcity of potential new terminal sites, together with the high cost of acquiring vessels, creates a barrier to the entrance of other ferry operators. As a result, there is little competitive pressure on BC Ferries.

The Commissioner is responsible for regulating the provision of core ferry services and the fares charged for those services. The Commissioner's mandate also includes protecting the financial viability of the ferry operators—currently only BC Ferries.

The Commissioner monitors service to ensure that it complies with the contract and monitors fares to ensure that price caps are not exceeded. Price caps represent the maximum average fare that can be charged within a route group. Individual tariffs may exceed the cap as long as the average does not.

For the initial (current) performance term, the price caps were set out in the *Coastal Ferry Act*. Before this term expires in 2008, the Commissioner must establish price caps for each route group

(see Sidebar on pages 26 and 27). Price caps are to be based on the cost of core service, plus a reasonable return on equity, less a productivity factor, if any. The Commissioner may also specify allowable annual increases for inflation, as well as approve price cap increases for extraordinary situations beyond the control of the company. An example of the latter situation was the approval of fare increases to accommodate unexpected increases in fuel prices in 2005 and 2006.

The Commissioner has identified a potential problem in this process. If, in their negotiations, the Province and BC Ferries agree on changes to the contract, the Commissioner will have only three months to adjust the price caps to reflect these. If the changes are in service fees, the adjustment should be promptly made. If, however, there are changes to core service requirements, re-costing the core services in such a short time frame could be difficult. In addition, if the changes to core services are significant, it may be necessary to obtain public input, which would require yet more time.

It is important that the Commissioner be informed at an early date of potential changes. It is likely that BC Ferries, with its greater knowledge of its capabilities and cost structure, would be the one to identify opportunities for greater efficiencies, yet the company may be reluctant to be perceived as the initiator of core service level changes.

The Commissioner believes that there is a risk that ideas for economically efficient changes may not be (a) generated (b) conveyed to government and (c) considered in timely fashion. Under the current arrangement he does not see how this risk will be mitigated, but has stated he is open to playing a facilitative role.

How price caps will be determined

Regulation of BC Ferries follows a modified price cap model. The price caps specify the maximum average fare that can be charged on each route group over each quarter. Individual fares are allowed to exceed the cap at times as long as the average does not.

There are seven route groups. The *Coastal Ferry Act* requires the British Columbia Ferries Commissioner to set the price caps so as to enable the ferry operator to recover operating costs, finance charges, administrative expenses and capital costs. The price caps must also allow the operator to earn a reasonable return on equity as defined by the Act. Provision may be made for annual increases equal to the consumer price index less productivity factors.

The productivity factor is an adjustment to allow for, and encourage, improvements in efficiency by the company. If the Commissioner believes efficiency should be improved, he or she may deduct a productivity factor from the price cap. This will reduce revenue, so BC Ferries must reduce costs to maintain its return on equity.

In determining an appropriate productivity factor, the Commissioner can take into account any offers that BC Ferries may have received for alternative service delivery. For example, if BC Ferries had turned down potential additional revenue related to renting a portion of the terminal, the Commissioner can consider this to be forgone revenue and penalize BC Ferries through the productivity factor.

The productivity factor may also be positive—that is, the allowable annual increase can exceed inflation if the Commissioner feels that this is necessary.

Price caps were established for the initial performance term by the *Coastal Ferry Act*, based on the fares in effect at the time of restructuring. The Act also established allowable annual increases over the first performance term. In subsequent performance terms, price caps will be set by the Commissioner. Price caps apply only to core services.

The core services to be provided are determined by the Province and set out in the Coastal Ferry Services Contract. The Commissioner then determines what costs are reasonable for these core services and what fare revenues can be reasonably expected. He or she can engage outside assistance to develop this information.

The process of determining price caps will start 18 months before the end of the term, when the company must provide the Commissioner with information on the core services to be provided, rates charged, projected revenue and expenses. As well, the company must provide all requests for proposals issued for alternative service delivery programs and responses received, unsolicited proposals received for service delivery, and any other relevant information.

Although regulating only core services and the fares for these, the Commissioner considers all revenues and costs, including those for ancillary services, in arriving at the price caps. Exhibit D on page 41 illustrates the points at which the Commissioner will apply key regulatory decisions to the company's finances.

Twelve months before the end of the performance term, the Commissioner must issue his preliminary price cap rulings to the Province and BC Ferries who will then negotiate the service levels and service fees for the next performance term. They must complete these negotiations nine months before the end of the term. The results of the negotiations will then be provided to the Commissioner, who will amend the price caps for changes made in service levels and fees, and issue a final ruling on the next term's price caps six months before the end of the current term.

Extraordinary price cap increases

Under certain conditions, the Commissioner may approve an extraordinary price cap increase. These conditions include deployment of a new vessel, an extraordinary increase in costs beyond BC Ferries' control, such as fuel, and unexpected changes in traffic levels or regulatory costs.

When an extraordinary increase is requested, the Commissioner must issue a preliminary decision to government and BC Ferries within 30 days of receiving all the information necessary to process the request.

Government and BC Ferries must then meet within 10 days to discuss whether the Province wishes to increase its service fees for the affected routes. If the Province chooses to increase its service fees, the Commissioner will amend or withdraw his decision and any increase in fares will be reduced or eliminated. If the Province does not choose to increase its service fees the preliminary decision will become final no later than 30 days after it is issued.

In either case, once the Commissioner has approved an increase, BC Ferries is assured of receiving additional revenue. Government may choose to "buy down" any increase in fares paid by users, but does not have the power to disallow the increase without increasing the service fees it pays.

To enable the Commissioner to perform his function, BC Ferries must provide quarterly and annual reports on tariffs, ferry service provided, vessel capacity and other matters, as well as any other information that the Commissioner may require about the core ferry service. If the Commissioner finds that contracted service levels are not being met or that price caps are being exceeded, he or she can issue an order to the company to comply fully with the contract. Not complying with such an order is considered to be an offense under the Act and, if found guilty, the company could be fined up to $500,000. The Commissioner could also reduce the price cap for the affected route group.

The Commissioner can authorize a reduction in service on any route for a temporary period, in extraordinary circumstances. He can also authorize discontinuance of a route, if he is satisfied that increasing fares on the route would still not be sufficient to make the route economically viable.

The Commissioner is appointed by the Lieutenant Governor in Council for a term of six to eight years, and the government cannot terminate the appointment except under exceptional circumstances. Neither can the Commissioner's remuneration or terms and conditions of appointment be changed without his or her consent.

Funding for the Commissioner's Office is not subject to annual appropriation by the Legislative Assembly, but is based on a formula set out in the *Coastal Ferry Act*. The monies must be provided by the ferry operators, currently only BC Ferries. If necessary, the Commissioner can request additional funding, which must also be paid by BC Ferries.

Are government's objectives likely to be achieved with the mechanisms in place?

The Act has been in place for less than four years, and it is too soon to determine fully whether the objectives will be achieved. We expected, however, to find mechanisms in place that will work to bring about the desired results.

Such mechanisms are designed to bring about the desired results by reinforcing or discouraging actions taken, or under consideration, by BC Ferries. The commercial approach adopted by BC Ferries is an example of such a mechanism—it is intended to put pressure on the company to be as efficient as possible. Other examples include: the removal of government's ability to make financial and operating decisions for the company; the actions of the regulator; alternative service delivery; and various requirements in the Act and agreements between government and BC Ferries.

We found that the separation of public policy and business decisions appears to have been achieved by the creation of the independent authority. We note, however, that this has resulted in B.C. Ferries no longer being directly accountable to any owner. This has the potential for unintended consequences in future.

Objectives to improve governance

Governance—that is, who is responsible for what decisions—must be clear if ferry operations are to run as smoothly and economically as possible. Furthermore, improving governance can be viewed as part of ensuring long-term sustainability (the second part of government's objectives).

Public policy decisions have been separated from the operating and financing decisions of the ferry system

To resolve the lack of clarity around governance identified in earlier reports, including reports issued by this Office, government determined that it should retain the ability to implement its public policy decisions, but that business decisions should be made by BC Ferries, based on business reasons.

To separate these roles, legal ownership of the operating company was transferred to the B.C. Ferry Authority, which was created to be independent of government. As a result, BC Ferries now makes its own decisions concerning operations, capital expenditures and financing. It is required to provide the core services set out in the Coastal Ferry Services Contract, but has the freedom to determine how it will provide those services. It is also able to pursue ancillary revenues through restaurant meals, gift shops, parking and reservation fees and the provision of other services.

The new governance structure is a hybrid, however, and has yet to prove itself. The Authority is accountable neither to government as a Crown corporation, nor to shareholders as a private corporation. Within the confines of the *Coastal Ferry Act* and the Coastal Ferry Services Contract, the Authority has a high degree of independence. This in itself carries some risk.

- *There is a risk that, as BC Ferries is not directly accountable to any shareholder, it has less incentive to perform well than it would if it was required to answer to its owners. This may have a negative impact on government's ability to fully achieve its objectives for the ferry system.*

One of government's objectives is to reduce costs to the taxpayer. Granting BC Ferries independence from government has incurred some additional monetary costs, however, such as liability for Goods and Services Tax, and higher interest on debt than would be expected if government were the borrower. In order to offset these costs and achieve additional savings, the new BC Ferries must continually outperform the old corporation. If a future board of directors should become complacent and accept a "business as usual" point of view, performance could deteriorate. Under the new structure, there is no one who can take direct action to correct this.

There are other mechanisms working to ensure good governance. The BC Ferries Commissioner can encourage greater productivity when setting the price caps. As well, because of its private sector borrowings, BC Ferries must comply with securities regulations, including those relating to governance practices.

As well as maintaining the independence of the board, the selection process for selecting directors of the Authority ensures that those most affected by the ferry system are represented on the board.

The Act required that the Authority's board prepare a profile of the skills and experience required by the board as a whole to carry out its duties. This has been done, and the board is required to ensure these skills and expertise are represented on the board.

BC Ferries operates under considerable public scrutiny, both through the media and through disclosure required under the *Coastal Ferry Act* and the Coastal Ferry Services Contract. It is required to provide comprehensive information about its financial and operating results, and both the Authority's and the operating company's annual general meetings are open to the public.

Ultimately, of course, government has the power to repeal or revise the *Coastal Ferry Act*, returning BC Ferries to a Crown corporation, abolishing it, or re-creating it in another form. This would be a major step, however, and would not be taken lightly.

None of these mechanisms, however, entirely replace the ability of the shareholders of a company to hold the board of directors responsible for its performance. For that reason, we concluded that although the risk is mitigated, it is not eliminated. We believe that government should monitor BC Ferries performance in relation to government's objectives, so that any problems can be identified and appropriate action determined at an early stage.

We recommend:

That government establish criteria for evaluating how well the coastal ferry system is achieving the objectives of the transformation and conduct evaluations of that performance, at least once in every performance term, in order to determine when or if changes to the Coastal Ferry Act *should be made.*

- *There is a risk that the Province will no longer be able to achieve its goals in relation to the level of ferry services provided to coastal communities.*

This risk has largely been addressed through the Coastal Ferry Services Contract, which enables the Province to ensure that the desired level of ferry service is provided. The current contract obliges BC Ferries to maintain ferry service on each designated route. The Province pays service fees for each sailing on the loss-making routes (including the Gulf Islands and Northern routes)—fees that are specified in the contract, along with the

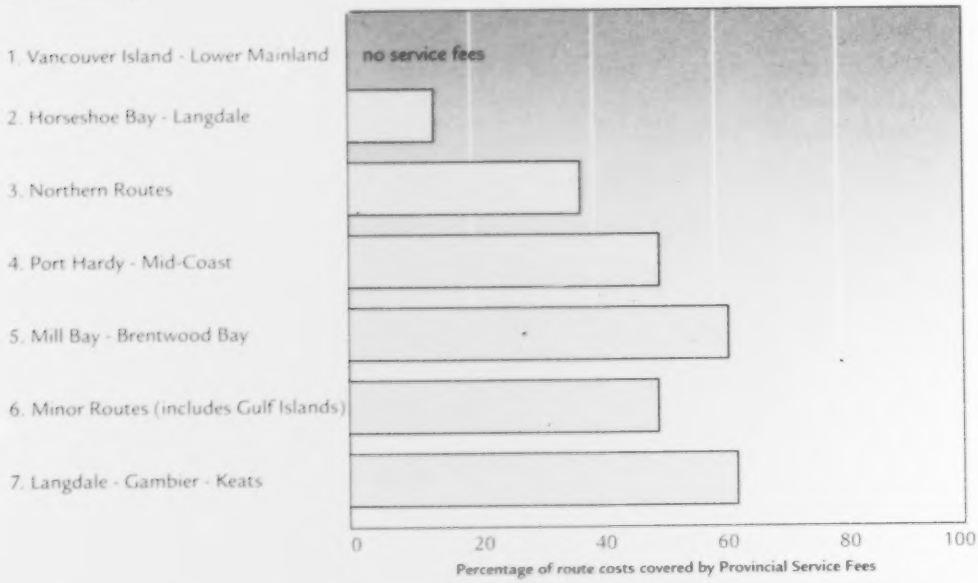
number of sailings required and the hours of operation. The contract also lists the capacity required for each route. As already noted, designated routes and service levels for this first performance term are those that were in effect during the year ended March 31, 2003.

The Province can influence the fares charged through the service fee it pays for each route. Service fees are to be re-negotiated between government and the company at the start of each performance term. For example, should government feel that fares for the Southern Gulf Islands routes are too high, it can increase the service fee it is prepared to pay for those routes. The higher amount will result in a lower price cap for that route group, and therefore lower fares. Alternatively, by reducing the fee it is prepared to pay, the Province can effectively raise fares. (While government can indirectly reduce fares on any route, it can only cause them to increase on those routes which already earn service fees.)

Exhibit B shows the average percentage of route costs, in each route group, paid by Provincial Service Fees.

Exhibit B

Provincial Service Fees as a percentage of route costs from April 1, 2003 to March 31, 2006



Source: British Columbia Ferry Services Inc. *Annual Report to the British Columbia Ferry Commissioner* for the years ended March 31, 2004 to 2006.

The previous British Columbia Ferry Corporation provided subsidized travel for seniors, schoolchildren, the disabled and those with certain medical problems. This achieved non-ferry-related policy goals, but at the expense of ferry revenues. The same subsidized travel is available under the new structure, but BC Ferries is now reimbursed by government for the forgone revenue. This leaves its operating revenue intact, while the costs to government for these social programs are identified.

- *There is a risk that, despite the changes, BC Ferries will still not have full control over operational decisions.*

This risk has been addressed through the *Coastal Ferry Act*, which grants BC Ferries sufficient independence from government to control its own operating decisions. The best indication to date that BC Ferries is able to make its own business decisions is its choice, following a worldwide tendering process, to have three new C-class ferries built overseas. More recently, the contract for the proposed

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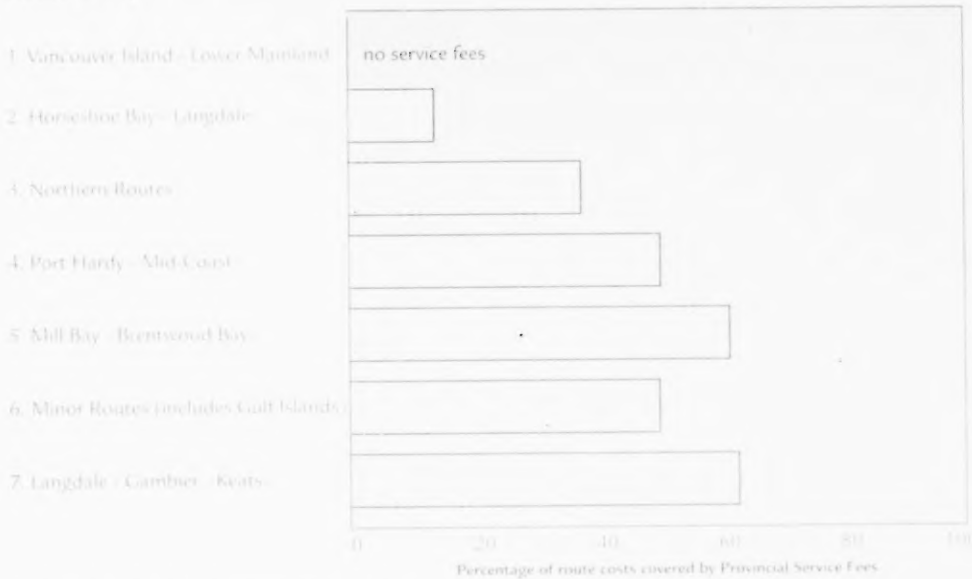

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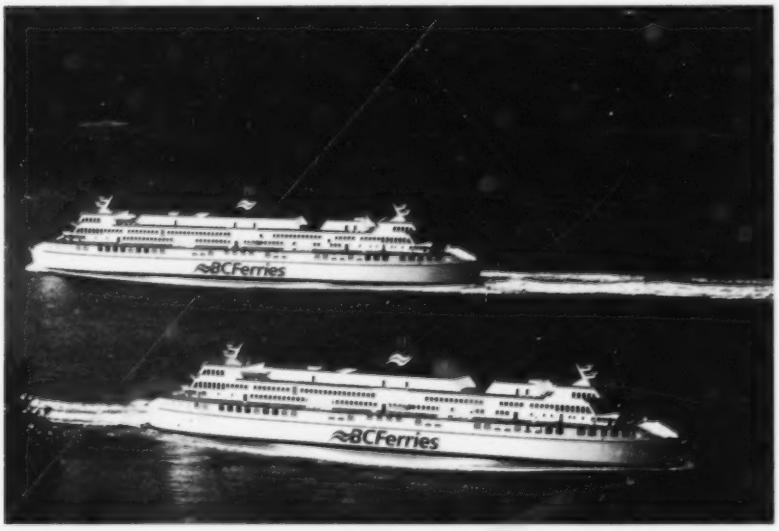
replacement for the *Queen of Prince Rupert* has also been placed with the same German shipyard. BC Ferries determined that it could save a significant amount of money by doing this, but the decision was controversial because, with few exceptions, in the past new ferries have been built in British Columbia. Whether one agrees or disagrees with BC Ferries' decision, the fact that the company was able to make the choice suggests that business and public policy decision-making are now separate.

Artist's rendition of new C-class ferries in Active Pass



Source: British Columbia Ferry Services Inc.

Reporting requirements have made the cost of the ferry system transparent

Both the *Coastal Ferry Act* and the Coastal Ferry Services Contract require a significant amount of disclosure of financial and other information. By requiring transparency of costs, the Province intends to keep BC Ferries accountable to government and the public for the provision of ferry services. Such transparency will assist the public and Members of the Legislative Assembly in judging the success of BC Ferries' transformation.

Transparency means that the cost of ferry operations must be readily available and understandable. In the past, revenues from the profitable major routes went to support service on other routes. The *Coastal Ferry Act* requires that such "cross-subsidization" be eliminated. This means that the revenues and costs of every route group be identified so that the net cost of each can be readily determined.

The Coastal Ferry Services Contract—a public document—discloses the service fee for each sailing on each route (see Exhibit C). The total of these service fees is disclosed in the annual Estimates tabled in the Legislature, and is subject to the scrutiny of legislators through debate on those Estimates. The costs to government for other policy goals, such as the social programs referred to earlier, are also set out in the contract.

Exhibit C

Provincial Service Fees by Route

			Service Fee per Core Round Trip $	Maximum Annual Service Fee $
Group 1		**Major Routes**		
	Route 1	Tsawwassen - Swartz Bay	0	0
	2	Horseshoe Bay - Nanaimo	0	0
	30	Tsawwassen - Nanaimo	0	0
Group 2				
	Route 3	Horseshoe Bay - Langdale	1,677	5,000,000
Group 3		**Northern Routes**		
	Route 10	Port Hardy - Prince Rupert	43,496	5,300,000
	11	Prince Rupert - Skidegate	42,669	8,100,000
Group 4				
	Route 40	Port Hardy - Mid Coast	48,547	1,900,000
Group 5				
	Route 12	Brentwood Bay - Mill Bay	443	1,400,000
Group 6		**Minor Routes**		
	Route 4	Swartz Bay - Saltspring	1,753	5,000,000
	5	Swartz Bay - Outer Gulf Islands	3,170	10,900,000
	6	Crofton - Saltspring	277	1,400,000
	7	Saltery Bay - Earls Cove	3,257	9,400,000
	8	Horseshoe Bay - Bowen Island	929	5,200,000
	9	Tsawwassen - Gulf Islands	8,313	6,900,000
	17	Comox - Powell River	4,302	6,300,000
	18	Powell River - Texada	890	3,200,000
	19	Nanaimo Harbour - Gabriola	445	2,500,000
	20	Chemainus - Thetis - Kuper	619	2,500,000
	21	Buckley Bay - Denman	438	2,700,000
	22	Denman - Hornby	469	2,100,000
	23	Campbell River - Quadra	463	2,900,000
	24	Quadra - Cortes	1,240	2,600,000
	25	Port McNeil - Alert Bay - Sointula	800	3,200,000
	26	Skidegate - Alliford	605	2,600,000
Group 7				
	Route 13	Langdale - Gambier - Keats	123	500,000

Source: Coastal Ferry Services Contract

The contract requires BCFS to hold an annual public meeting at which members of the public can ask questions and express their views. The company must also make copies of its audited financial statements, its annual report to the British Columbia Ferries Commissioner, and its Business Plan for the next year, publicly available. The report to the Commissioner includes financial statistics, traffic level numbers and other operating statistics on all designated routes. Although it is not a legal requirement, BCFS currently posts these reports on its website.

Similarly, the *Coastal Ferry Act* requires the B.C. Ferry Authority to open its annual general meeting to the public, to allow members of the public to address the meeting, and to make available its annual report and audited financial statements. As well, the Act requires BCFS to provide detailed information to the Commissioner regarding services provided, revenues earned and expenses incurred. This does not directly make the cost of the ferry system more transparent to the taxpayers, but does provide additional assurance that the costs are fair and reasonable through reliance on the Commissioner. Information relied on by the Commissioner in making decisions must be made available to the public, subject to the *Freedom of Information and Protection of Privacy Act*.

These reporting requirements ensure that a significant amount of information will be available to the public.

Objectives to ensure long-term sustainability

Long-term sustainability of the ferry system requires that ferry operators (i.e., BC Ferries) should be financially viable and in a position to make the infrastructure investments needed to continue providing ferry service into the future.

As stated, we determined that there were three objectives under this intent:

- minimizing the cost to the taxpayer of providing service;
- protecting the ferry system; and
- improving service.

Several mechanisms are aimed at minimizing the cost of the ferry system to the taxpayer

Revenue to pay the cost of ferry services, including new ships and other infrastructure, comes from two main sources: users of the ferry system and taxpayers. The biggest source of revenue is user fees (fares). There are also ancillary service revenues, mainly from the sale of food and fees for parking or reservations.

Actual revenues for the year ended March 31, 2006, were as follows, in millions:

Fares	$354
Social program reimbursements	$ 15
Core service fees	$ 93
Ancillary revenues	$ 69
Federal subsidy	$ 25
Other	$ 23

Source: British Columbia Ferry Services Inc. reports

The taxpayers' contribution consists of a federal subsidy, fixed by an agreement between the federal and provincial governments and changing only with inflation, and the service fees paid by the Province. The Province also reimburses BC Ferries for subsidized fares under social programs, as mentioned previously.

Minimizing costs to the provincial taxpayer means minimizing the service fees. The *Coastal Ferry Act* includes several mechanisms to minimize those, including: shifting more of the cost of services from taxpayers to ferry users by reducing service fees relative to fares; expanding ancillary services and using surpluses from these services reduce the need for service fees; using regulation to foster economic efficiency; and seeking alternative service providers. Each of these mechanisms is described further below, along with any risks that we identified.

Shifting more cost to the ferry user

One of the principles guiding the British Columbia Ferries Commissioner is that the designated ferry routes should move towards a greater reliance on a user-pay system. The goal is to reduce, though not necessarily eliminate, government contributions to the cost of the service. How far the system should move toward

the user-pay model is not explicitly stated. The marketplace could be used to determine this extent—for example, demand for ferry service at various prices would indicate the price at which net income is maximized. Government may, however, choose to maintain fares at a lower level (through adjusting its service fee) as a matter of public policy.

We note that ferry service on major routes between Vancouver Island and the Lower Mainland is already user-pay as no service fee is paid on these routes, nor do they receive any of the federal subsidy.

Expanding ancillary services

Government believes that a more commercial approach, with an emphasis on profitability, will work to decrease costs and maximize revenues for BC Ferries. There are numerous indications of the company taking a more commercial approach in increasing ancillary revenues, such as building a new retail outlet, Tsawwassen Quay, and expanding the reservation system on major routes.

Tsawwassen Quay

Source: British Columbia Ferry Services Inc.

Increased ancillary revenues would normally go to increase the wealth of shareholders. BC Ferries, however, pays no dividends (except for fixed payments to the Province on its preferred shares). Retained earnings from increased ancillary revenues may therefore be used to offset the costs of providing core services or go towards fleet replacement and other infrastructure improvements. There is, however, risk associated with unsuccessful ancillary services.

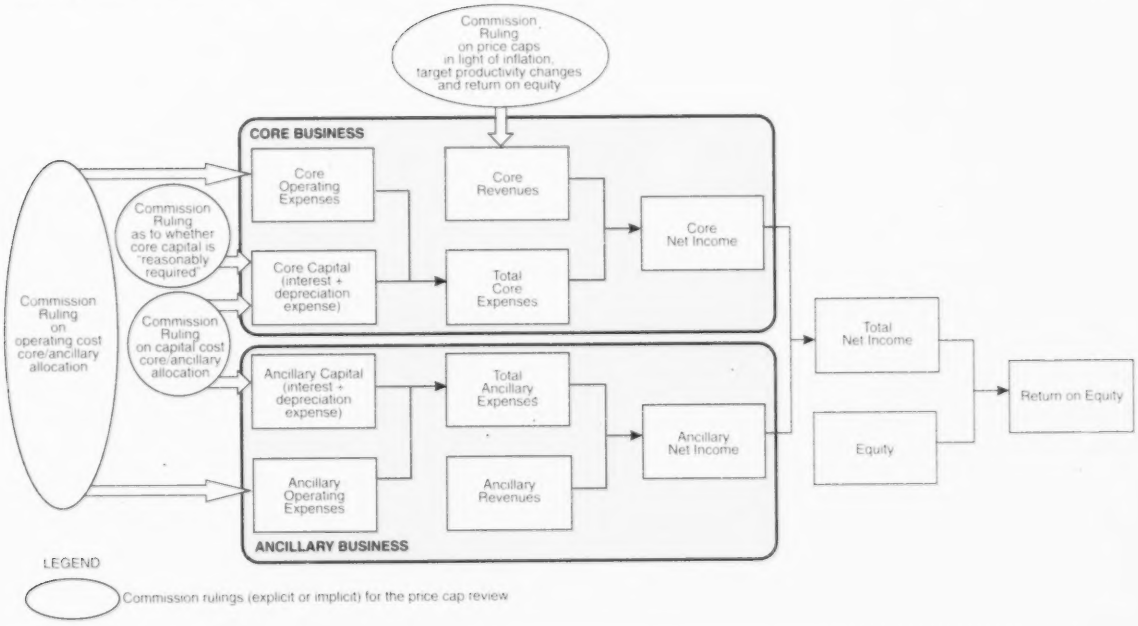
■ *There is a risk that poor performance in ancillary services could result in higher fares or service fees.*

Poor ancillary performance is not intended to result in increases to fares or service fees, but we believe that there is a risk this could occur and there appears to be no mechanism to fully mitigate it.

In the model shown in Exhibit D, the British Columbia Ferries Commissioner's ruling on price caps at the start of a performance term takes into account expected ancillary revenues. Ancillary profits greater than the anticipated amounts will benefit the company by providing a higher return on equity, at least until the next performance term, when the price caps will be re-calculated using the new levels of revenue.

Exhibit D

Key regulatory decisions


Commission Ruling on price caps in light of inflation, target productivity changes and return on equity
CORE BUSINESS
Core Operating Expenses
Core Revenues
Core Net Income
Commission Ruling as to whether core capital is "reasonably required"
Core Capital (interest + depreciation expense)
Total Core Expenses
Commission Ruling on operating cost core/ancillary allocation
Commission Ruling on capital cost core/ancillary allocation
Ancillary Capital (interest + depreciation expense)
Total Ancillary Expenses
Ancillary Net Income
Ancillary Operating Expenses
Ancillary Revenues
ANCILLARY BUSINESS
Total Net Income
Equity
Return on Equity
LEGEND
Commission rulings (explicit or implicit) for the price cap review

Source: British Columbia Ferries Commissioner

On the other hand, government expects that if the company loses money because of ancillary services, the result will be a reduced return to the company rather than higher service fees or tariffs on core services. We question, however, whether such losses could be ignored in all cases. As Exhibit D shows, ancillary net income

forms part of total net income. This is used in calculating BC Ferries' return on equity, which in turn is used to determine new price caps. In an extreme case, excluding poor ancillary performance could affect the return on equity to the extent that the company would be in financial danger. The Commissioner would then have to balance the risk to BC Ferries, with the accompanying risk of loss of service, against providing too much security to the company.

The Act provides several principles to guide the Commissioner, one of which states that priority is to be placed on the financial sustainability of the ferry operator. At the same time, the Act provides for the possible bankruptcy of the company, suggesting that the operator's survival is not guaranteed. It is not clear how such opposing possibilities will be accommodated or how the Commissioner will trade off protecting the financial viability of the ferry operator against the interests of taxpayers and fare-paying passengers.

The Commissioner is to use his or her regulatory powers to encourage BC Ferries to minimize expenses

Another principle set out for the Commissioner is to encourage the company to minimize expenses, as long as it does not affect the safety of ferry services.

The Commissioner is to be given access to all necessary cost information when he or she is establishing price caps for the route groups. If the Commissioner considers that costs are excessive, he or she can set the price caps at a level that will require the company to reduce these costs. As an additional incentive to reduce costs, the Commissioner may include a productivity factor, as discussed in the sidebar on page 26. Also as noted above, the Commissioner has been given the power to enforce his or her orders by imposing financial penalties on the company. We believe there is a risk associated with such penalties.

■ *There is a risk that penalties imposed on BC Ferries will not be effective.*

The effect of financial penalties on BC Ferries may be reduced because of the lack of shareholder control. Normally, such penalties reduce the financial return on the shareholders' investment, providing a strong incentive to avoid incurring the penalties. BC Ferries, however, has no shareholders—the directors who control the company do not have any monetary investment

in the company nor do they answer to shareholders who do. While the directors would still be motivated to avoid penalties to the company, they would risk little personal loss if penalties are imposed. Financial penalties may ultimately be passed on to those who pay for the ferry system, taxpayers and fare-paying users, in a manner similar to any ancillary losses as discussed earlier.

- *There is a risk of "regulator capture", in which the regulator identifies with the interests of the regulated company rather than maintaining an objective position.*

This risk is inherent in any regulatory situation, since effective regulation depends on the objectivity of the regulator. Because the regulator, by virtue of his or her position, must frequently interact with the regulated entities, there is a danger that such objectivity could be eroded.

The risk cannot be completely avoided, however a regulator can reduce the risk through being aware of the danger. Although this review was not intended to examine the actions of the British Columbia Ferries Commissioner, during our interviews the Commissioner advised us that he is aware of the risk of regulator capture, and has taken steps to minimize the risk for both himself and his deputy.

BC Ferries is to seek alternative service providers of core ferry services

Under the Act, BC Ferries is required to seek alternative service providers to provide ferry service at lower cost. Competition is generally accepted as a prime motivator for companies to improve efficiency and reduce costs, and this requirement is intended to place competitive pressure on BC Ferries. The Commissioner is to encourage the company in finding alternative service providers. The company must, once in each performance term, develop a plan to attract additional or alternative service providers and submit this to the Commissioner. The Commissioner can use the productivity factor to penalize BC Ferries if he feels the company has not taken advantage of an opportunity to lower costs by using an alternative service provider.

There is uncertainty about how this section of the Act will work in practice.

- *There is a risk that competitive pressure will not be achieved, and that no cost reduction will result from this requirement.*

Introducing competition will not be easy. BC Ferries has been charged with planning and coordinating public and private sectors in providing a transportation service, much like the Vancouver International Airport Authority. Unlike the Airport Authority, however, which does not operate an airline, BC Ferries has exclusive control over nearly all existing ferry terminals and is by far the largest ferry company in the province. The fact that it is not required to grant any other ferry operator access to its terminals, together with the relative scarcity of alternative terminal sites, significantly contributes to BC Ferries' monopoly position.

BC Ferries' role as service integrator puts it in a potential conflict of interest: it could be accepting tenders from alternative service providers while at the same time preparing its own plans for offering the services it is offering to outsource.

To address this problem, the company had intended to establish a "Chinese wall" — BC Ferries would prepare its own tenders but staff involved in tendering would not have communicated with those who would have evaluated the tenders. An independent "fairness auditor" would have been engaged to comment on the efficacy of the Chinese wall. BC Ferries, however, has determined that this process would be inefficient and cause serious operational difficulties.

In its February 2006 *Update and Supplement to the Additional or Alternative Service Providers Plan*, BC Ferries states that it will instead adopt a more traditional outsourcing approach. It will not submit formal tenders to itself, but will instead determine the cost and risk profile of continuing to provide the service directly. This will serve as a benchmark against which to evaluate external proposals. To ensure fairness, the benchmark will be prepared prior to the closing date of any competition.

A fairness auditor will not be engaged, however BC Ferries' business case, on which the company will base its decision on any alternative service proposal, will be subject to an independent external review. The final report of this review will be provided to the BC Ferries Commissioner.

In spite of BC Ferries' efforts to ensure fairness, the company still has advantages over other potential service providers. It has a wealth of information about demand for ferry services and costs of providing them. Its administration systems are in place, and its

In 2005, BC Ferries started processes to identify qualified service providers for the Brentwood/Mill Bay route and the Northern Routes. Expressions of interest were received for both, however neither process has gone beyond this stage as yet. The process to identify a service provider for the Brentwood/Mill Bay route is scheduled to complete by April, 2007. Following the sinking of the *Queen of the North*, BC Ferries approached the proponent for the Northern Routes process who submitted a conceptual proposal, however it contained insufficient information. BC Ferries is currently reviewing its plans for seeking alternative service delivery on the Northern Routes.

administrative costs would change little if it had one route more or less—the only significant change in costs in introducing a new route would be the direct costs of operating that route. A new service provider may have to recover its overhead costs, as well as its direct costs, from a single route. This would make it harder for new providers to compete.

For the reasons discussed previously, we believe that reducing the cost of ferry services by introducing an element of competition will be difficult to achieve.

Steps taken to protect the ferry system in the long term seem reasonable to meet that objective

Protecting the ferry system means that the ferry operators (at present only BC Ferries) have an environment in which they can survive while meeting the terms of the contract. BC Ferries has been given the ability to replace capital assets as necessary, and has also been given specific protections in the Act and the contract.

BC Ferries is virtually assured sufficient cash flow to cover the cost of necessary new capital assets and operations

With the apparently successful separation of public policy and operating decisions, BC Ferries has the ability to follow a plan for rational replacement of its ships and other infrastructure. This should result, over time, in regular replacement of assets, so that funding requirements are predictable—that is, so that no "catch-up" expenditures are necessary. Maintenance costs should also be reduced as older ships are replaced.

The Act provides BC Ferries with assurance that the cost of new infrastructure will be recovered. Before purchasing a ferry or other capital asset, BC Ferries can request agreement from the Commissioner that the asset is necessary. Once such agreement is given, the Commissioner must include the cost of that asset in the calculation of price caps.

The company is also protected against policy changes by government. Should government choose to reduce, or to decline to raise, its service fee at the start of a performance term, such that a route becomes uneconomic, BC Ferries could apply for discontinuation of the route. Permission to discontinue a route would be granted by the Commissioner, not government. If a route

was discontinued and BC Ferries could not redeploy the assigned ship, the company could require the Province to purchase the "stranded" vessel.

A similar condition applies should all routes to and from a terminal be discontinued as a result of government decisions. In such a case, BC Ferries is entitled to a refund equal to the net book value of all leasehold improvements to the facilities.

Service fees are fixed at the start of each performance term. Where costs not under the control of BC Ferries escalate during the term because of unforeseen circumstances, the company can request, of the Commissioner, an extraordinary increase in the price caps. An example of this is the adjustment for higher than expected fuel costs in 2005 and 2006.

The ferry operator has specific protection in the Act

The Act states that the priority of the Commissioner is the financial sustainability of the ferry operators. There is a risk that this priority will conflict with the objective of minimizing cost to the taxpayer, as has already been discussed. The lack of an alternative ferry operator who could provide the service may also influence the Commissioner's decision in such a case.

Ferry assets are protected against being removed or made unavailable for service

In the Coastal Ferry Services Contract, there are several clauses which work to prevent ships or terminals being removed from service.

First, the ferries cannot legally be sold and taken out of service unless government allows it. The contract gives the Province the option to purchase the vessels from BC Ferries at net book value, and the Province may exercise this option should the company be in default of the contract.

Second, the ferries cannot be seized by creditors and taken out of service. BC Ferries has the power to borrow and to pledge the ferries as security for its debt. Should the company default on that debt, however, and the ferries be seized, the creditors would be bound to continue providing service in accordance with the contract.

Third, the ferry terminal properties can be used only for the purpose of ferry terminals. The transfer of the terminals to the BC Transportation Financing Authority, a Crown corporation, ensured that these will remain the property of the Province. The Terminal Leases allow BC Ferries exclusive use of these terminals as long as they are being used in providing ferry services. Should BC Ferries default on the contract, the Province has the right to terminate the leases.

Finally, the operating company, British Columbia Ferry Services Inc., cannot be sold without the consent of government. The terms of the preferred shares held by the Province are such that should the B.C. Ferry Authority sell the sole common share, the Province has an option to convert its preferred shares to common shares, giving it control and virtually full legal ownership of BCFS. This means that no purchaser can buy and retain full ownership of the company without the consent of government.

Steps taken to improve customer service appear to be on the right track for increasing demand and reducing net service costs

Despite BC Ferries' virtual monopoly, local users may choose to travel less if the service is poor, and tourists may choose to go elsewhere. Improving service can therefore be expected to result in more customers—and thus more core revenue, followed by more ancillary revenue. In the long run, this should reduce BC Ferries dependence on service fees.

Improved customer service is recognized as a government objective, but is not defined in either the Act or the contract. During our interviews, a steering committee member stated that improvement would be "whatever the customer defines it as." This sentiment is consistent with the increased commercial focus of the restructured ferry corporation. The marketplace will dictate what improvements are made, reflecting the preferences of the ferry riders.

There is also an implied accountability to the public in the government's objective to improve service. The contract requires BC Ferries to engage an independent organization to complete a customer satisfaction survey every year, report the results of this survey to both the Province and the Commissioner, and post the results on the company's website.

How is progress toward achieving government's objectives being monitored, measured and reported to government and the public?

The Minister of Transportation is responsible for administering the *Coastal Ferry Act*. In its annual service plan report, the Ministry states that the Province's contract with BC Ferries sets out measurable service levels, such as on-time trips, and payment of service fees is based on the company meeting these levels. We found that the Ministry monitors performance to ensure contracted service levels are met, but there is no monitoring of the new structure to evaluate how well it is meeting the objectives of the Act.

Earlier in this report we recommended periodic evaluations of the ferry service. These evaluations would address the absence of such monitoring.

Because the ferry system is no longer administered by a single corporation, but rather a collection of several separate legal entities, information about the ferry system is reported by more than one source. We believe that it would be of value to taxpayers, ferry riders and Members of the Legislative Assembly if a single summary of the various reports and public documents were available, providing information on the ferry system as a whole.

We recommend:

That the Ministry of Transportation issue, separately or as part of its annual service plan report, a comprehensive summary report on the coastal ferry system.

As mentioned, the Ministry of Transportation is currently monitoring the *quantity* of core service provided. However, although the contract requires the ministry and BC Ferries to develop performance measures relating to the *quality* of services, this has not been done to date.

We recommend:

That the Ministry of Transportation and BC Ferries develop performance measures relating to the quality of service, as required by the Coastal Ferry Services Contract.

The Commissioner's annual report is tabled in the Legislature each year. It contains all applications and requests for decisions, all orders issued, and all financial statements for that office. In his 2003/04 Annual Report, the Commissioner voiced a concern about the definition of reservations as an ancillary service. He drew government's attention to the reservation system on the Vancouver Island/Mainland and Sunshine Coast routes, in which customers pay a fee to reserve space. He pointed out that, although the Act defines reservations as ancillary and not subject to regulation, there was a risk that the company could exploit its monopoly position in the supply and price of reserved and unreserved spaces on these routes, particularly if demand were to increase. (Currently, the company has chosen to accept reservations on up to 40% of space on a sailing.).BC Ferries disagrees with the Commissioner's view, and maintains that the reservation system is an additional service to its customers, not a core service. Nevertheless, the Commissioner reiterated his view in his 2004/05 and 2005/06 Annual Reports, which strongly suggests that he has not received a satisfactory response to his original concern.

The Legislature is not obligated to respond to concerns raised by the Commissioner. Given that the new model for delivering coastal ferry services is not yet proven, however, it is desirable that concerns raised by the Commissioner should be fully addressed. He plays a key role in this structure and is well placed to identify potential problems and solutions. Legislators may wish to consider how best to address his concerns.

Looking ahead to the end of the first performance term

At the time that the transformation took effect, there was little visible evidence of change other than a new name and logo. Since then, orders have been placed for six new ships, including the purchase of the *MV Sonia*, requests for expressions of interest by alternative service providers have been issued on certain routes, and ancillary services have been increased, both on board and at the terminals. In addition, private sector financing has replaced the original debentures for $427.7 million, held by government. Changes that have had a direct impact on most ferry users are the increased ancillary services and fare increases, both scheduled increases and those due to fuel surcharges.

Much of the impact of the *Coastal Ferry Act* will not be felt by the public until the end of the first performance term, in Spring 2008. At that time, service levels and fees will be re-negotiated between the Province and the company. It is possible that service on some routes will be reduced or even discontinued, while other routes may see increased service. The British Columbia Ferries Commissioner will set new price caps on the routes. Fares will likely rise, but it is at least theoretically possible that some could fall, such as on the profitable routes between the lower mainland and Vancouver Island.

The *MV Sonia* is expected to enter service in 2007 and increased service fees for the routes served by the *Sonia* have already been negotiated. The first of three new C-class ferries will be delivered in late 2007, with the others following in 2008. Replacements for the *Queen of Tsawwassen* and the *Queen of Prince Rupert* will enter service in 2008 and 2009 respectively. Both fares and service fees will be affected by the need to pay for these necessary replacements.

Other changes may occur over the next few years as well. For example, additional ancillary services may be offered to the ferry rider, possibly at extra cost. An example is the new Seawest Lounge on the *Spirit of British Columbia*.

As noted earlier, it is too early to fully evaluate the changes made to the coastal ferry system. Subject to the concerns already mentioned, however, we believe that the new structure is a reasonable one, in the context of government's objectives, with the potential to achieve those objectives. We look forward to the second performance term, and to watching the ferry system develop.

Response from the Ministry of Transportation

Response from Ministry of Transportation

The Ministry of Transportation is pleased to provide its formal response to the Office of the Auditor General's report entitled "Changing Course – A New Direction for British Columbia's Coastal Ferry System".

General Response:

There is consensus that the report accurately reflects the steps the Province of British Columbia has taken in setting a new direction for the delivery of coastal ferry services.

The ministry agrees with the conclusion that the establishment of the B.C. Ferry Authority, British Columbia Ferry Services Incorporated (BC Ferries) and the British Columbia Ferry Commission have achieved the immediate objective of separating government policy decisions from the business decisions of BC Ferries.

The ministry continually looks to improve the way it conducts its business, therefore we feel that periodic reviews of this new business model will help to ensure that the delivery of coastal ferry services continues to meet the objectives laid out with the transformation of BC Ferries from a Crown Corporation to an independent, regulated company.

Responses to Specific Recommendations:

With regard to the specific recommendations in the report, the ministry has the following comments:

Recommendation 1:
That government establish criteria for evaluating how well the coastal ferry system is achieving the objectives of the transformation and conduct evaluations of that performance, at least once in every performance term, in order to determine when or if changes to the *Coastal Ferry Act* should be made.

Response:

The Ministry of Transportation will consider the most effective process to implement this evaluation.

Recommendation 2:
That the Ministry of Transportation issue, separately or as part of its annual service plan report, a comprehensive summary report on the coastal ferry system.

Response:

The context of this recommendation in the report is that there is no single report that covers all aspects of the ferry system. The Ministry believes that the independent entities are best positioned to report on their activities on an annual basis. Each entity has different timelines for publishing their reports; therefore it would not be timely to issue a summary in the annual service plan report of the ministry.

In order to address the concern raised in the report that information about the ferry system is no longer available through a single source, the Ministry feels it would be beneficial to provide links to the individual reports on the Ministry's internet site.

The ministry's payments under the Coastal Ferry Services Contract are reported in its annual service plan report and are annually approved by the Members of the Legislative Assembly. The ministry will consider increasing the information provided in its annual service plan report.

Recommendation 3:
That the Ministry of Transportation and BC Ferries develop performance measures relating to the quality of service, as required by the Coastal Ferry Services Contract.

Response:

Reporting relating to the quality of service has been developed in the areas of on-time performance, customer satisfaction, and traffic congestion. The Ministry and BC Ferries will meet to discuss additional performance measures relating to the quality of service.

Appendix

Appendix

Office of the Auditor General: 2006/07 Reports Issued to Date

Report 1 – April 2006

Strengthening Public Accountability: A Journey on a Road that Never Ends

Report 2 – September 2006

The 2010 Olympic and Paralympic Winter Games: A Review of Estimates Related to the Province's Commitments

Report 3 – November 2006

Audit of Treaty Negotiations in British Columbia: An Assessment of the Effectiveness of British Columbia's Management and Administrative Processes

Report 4 – December 2006

Province of British Columbia Audit Committees: Doing the Right Things

Report 5 – December 2006

Audit of Government's Corporate Accounting System: Part 2

Report 6 – December 2006

Monitoring Government Finances: Province of British Columbia

Report 7 – December 2006

Government's Post-secondary Expansion—25,000 Seats by 2010

Report 8 – December 2006

Changing Course—A New Direction for British Columbia's Coastal Ferry System: A Review of the Transformation of BC Ferries

Each of these reports can be accessed through our website http://www.bcauditor.com or requested in print from our office.